

**STATE AND LOCAL TAXATION OF  
ELECTRONIC COMMERCE:**

**Read My E-mail, No New Taxes.**

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“The government's view of the economy could be summed up in a few short phrases: If it moves, tax it. If it keeps moving, regulate it. And if it stops moving, subsidize it.”

--President Ronald Reagan, 8/15/86 White House Conference on Small Business.

# Executive Summary.

President Reagan's observation about the aggressive tax mentality of government officials is sadly reflective of today's debate over the taxation of electronic commerce. Reacting to the growth in electronic commerce as a new revenue source and fearing the erosion of the existing tax base, State and local governments are needlessly threatening our nation's future economic prosperity.

Instead of applying traditional legal concepts to the taxation of electronic commerce, state tax bureaucrats are becoming legal contortionists in an attempt to tax Internet sales. The resulting confusion among prospective Internet merchants and service providers could substantially impede the development of electronic commerce. Electronic commerce is not a big business domain. The proliferation of high-speed, low cost computers and competitive access to telecommunications networks is a siren call to small businesses and individual entrepreneurs to seek their fortunes. Government's relentless pursuit of these new tax revenues will discourage up-start businesses from venturing out on the Internet and pursuing the American dream.

The irony is in civil service tax bureaucrats publicly arguing for expanded interpretations of our laws to cover electronic commerce, while elected policy makers are scouring the nation promoting their States as "business friendly" to entice these very companies to relocate to their states. California is no different. While Governor Wilson touts the State has a haven for the developing hi-tech industry, our tax agencies are considered by some to be the most aggressive in the nation. Perhaps a basic civics class on the joys of representative democracy is in order.

There is simply no need for the States to expend resources in pursuit of electronic commerce. Not only will the technology prove a difficult tax target but the threat to the existing sales tax base isn't real. Despite the meteoric rise in electronic commerce over the past five years, traditional State sales tax revenues continue to grow. To argue that electronic commerce will diminish the sales tax base you need to assume that consumers who purchase goods over the Internet are primarily motivated by the marginal tax advantage they may enjoy by acquiring goods out of state. The prevailing wisdom that out-of-state businesses necessarily enjoy a competitive advantage over local "main street merchants" is clearly exaggerated.

For those of us who believe that government has become too big, wasteful and involved in our daily lives, we see no need for *new* taxes on electronic commerce. State and local governments should be seeking

elimination of ineffective programs and reducing the scope of their activity. Congress is focusing on reducing government largess and reversing the 60 year trend of expansion. Why then tax the Internet job machine for additional tax revenue? Zealously pursuing new revenues, the States tax officials are expanding their reach to electronic commerce through novel theories of nexus which have resulted in a great deal of confusion among taxpayers. The lack of a uniform resolution to the taxation of interstate commerce is a substantial impediment to the growth of electronic commerce. Congress must act, as it should have long ago, to clearly identify the boundaries of state taxation of interstate commerce.

The federalist system as envisioned by our Founding Fathers granted Congress through the Commerce Clause the power to regulate commerce between States and with foreign nations. This authority granted Congress has certainly been misused to justify expansive federal powers. But the global implications of electronic commerce raise just the type of dilemma the Founding Fathers envisioned being resolved by Congress. Those who argue that federalism protects the absolute power of the State's to tax interstate commerce are simply wrong.

To ensure the Internet and electronic commerce continue to grow unimpeded by government taxation, Congress must take affirmative steps to do the following:

- (1) Prohibit State and local governments from imposing any taxes on access to the Internet.
- (2) Prevent State and local governments from imposing any taxes on electronically delivered goods and services.
- (3) Clearly define nexus to require actual physical presence by the merchant is required before a State can impose use tax collection and remittance requirements. Congress should include specific language establishing that Internet activity and contracts for services are insufficient to establish nexus.

A Congressional act is necessary both for purposes of uniformity and because the States are simply incapable of resolving these issues among themselves. Failure to act will perpetuate the confusion among merchants and service providers threatening this emerging market. Inaction by Congress will also squander millions of taxpayer dollars in litigation destined to fail to resolve the uncertainty in existing tax law.

# The World is Shrinking.

The distance that separates us is dwindling by the minute. Geography as an impediment to the exchange of information and commerce is becoming largely irrelevant. With each passing day society views physical distance as less of an obstacle to conducting commerce and living their lives. The advancement in network communications makes being in the same physical location unnecessary. The fully interactive, easy-to-use, ubiquitous “network of networks” providing the seamless pushing and pulling of information between users and providers, is clearly developing.

This global network of the future has many names: The Global Information Infrastructure, the Information Superhighway, the Internet (or the Net), and cyberspace<sup>1</sup> among them. A global network of computers lacking centralized control and performing automated communication functions.

It's not surprising that the growth in global networked communications has spawned an almost frenzied interest in electronic commerce by government tax officials. Projected global Internet purchases are estimated to grow from \$500 million in 1995 to a range of \$150 to \$600 billion by the year 2000<sup>2</sup> and global Internet users expected to grow by 76% within the same time frame.<sup>3</sup> Now everybody wants to get in on the act, including government.

The growth in electronic commerce isn't confined to the sale of goods and services *via* electronic means, it includes substantial related investments. The infrastructure that makes Internet communications possible (fiber optic, twisted wire, and broadcast technology), is forecast to grow by 87%<sup>4</sup>. The manufacture of equipment for Internet related services is forecast to grow by nearly 34%<sup>5</sup>. Related Internet services such as network management, development and maintenance are predicted to become a \$20 billion industry by the year 2000<sup>6</sup>. Just look at Microsoft and Disney for examples of the monumental possibilities in software and content development.

Growth in electronic commerce will not be the sole province of corporate America. Individuals and small business ventures will increasingly see cyberspace as a means for marketing and selling their products and services. For the individual entrepreneur seeking a market for the sale of their unique product or service, the Internet offers *instantaneous* access to a *global* marketplace. These new businesses will not always require expensive startup costs and overhead. Cyberspace will permit

them cheap access to the world's market place. Simply author a "home page," rent space from an Internet Service Provider and presto, instant global market availability. The wonder of cyberspace is that "word of mouth" travels at the speed of light and a new business could be launched without the proprietor ever leaving a computer. Disabled Americans will gain far more from Internet, than ADA will ever provide.

For our economy and citizens, growth in electronic commerce means new jobs. The industrial age economy is giving way to one based on the production and exchange of information. By encouraging the growth of electronic commerce we enhance the opportunities available for people to find work in cyberspace or a growing number of related service industries. The expanding job base will increase consumer spending, home purchases, and corporate profits. With no tax law changes, government is about to receive a windfall of sales, property, and income tax revenue.

Many government tax officials and organizations of tax bureaucracies have had unhealthy reaction to the media hype surrounding the growth of the Internet. With glee in their eyes, they seek new interpretations of tax law in an effort to increase the revenue collected by this fledgling industry. Their Pavlovian response is illustrative of two larger problems: those who cry most for taxing electronic commerce seem to understand it the least; and for them tax policy appears more about the naked pursuit of revenues to fund state and local general funds than of the application of just, fair, and uniform tax principles.

The current structure for taxing the sale of goods and services is based on concepts of physical assets, geographic locations, and face-to-face encounters. Commerce on the Internet is premised on digital technology where there is no locality, no physical presence, and no geopolitical boundaries. Being digital is being everywhere and being nowhere all at the same time. While it remains possible to administer traditional tax structures for products ordered over the Internet but delivered via mail or other common carrier, the States must stop the relentless torture of traditional legal concepts to seek more tax from the Internet.

The question of imposing new taxes on electronic commerce is as much an ideological debate about the role of government as about principles for an economically neutral tax system. Grover Cleveland in a speech to Congress once said that "when more of the people's sustenance is exacted through the form of taxation than is necessary to meet the just obligations of government and expenses of its economic administration, such exaction becomes ruthless extortion and a violation of the fundamental principles of a free government."<sup>7</sup> Rather than adopting policies of fiscal restraint and promoting more efficient delivery of

services, State and local governments are reaching out to expand their revenue base by threatening electronic commerce.

The City of San Bernardino, California recently sent letters to the large on-line service providers claiming they were providing “teletypewriter exchange services” and therefore required to collect the City’s Utility User Tax from customers. When the initial ordinance was drafted, the Internet and On-line Service Providers were fiction. At the urging of private contingency fee auditors, San Bernardino drafted a letter outlining their revisionist interpretation of the ordinance subjecting the large service providers to tax. Another example is the City of Tacoma, Washington last summer who proposed a 6% tax on Internet access to be collected by Internet Service Providers. The tax was rescinded after heated opposition from taxpayers. These efforts have a common thread: local politicians seek tax from those who don’t vote in their jurisdiction. Like many more subtle attempts nationwide, this tax zeal circumvents the scrutiny of the public and undermines the credibility of our tax system.

### **Basic Principles for the Taxation of Electronic Commerce:**

The public interest is served by the following principles guiding the taxation of electronic commerce:

- (1) No new taxes. Government doesn’t need the additional revenue and promoting the growth of electronic commerce will expand our economy and tax revenues. New taxes will only relocate growth to other markets weakening the competitive position of the United States.
- (2) Americans will benefit more by the rapid expansion of electronic commerce and information technologies than by the programs of state and local governments funded with the tax revenues extracted by taxing electronic commerce.
- (3) Traditional sales tax imposed on the sale of goods and services via electronic means should be simple to administer for the retailer being imposed upon to collect the tax.
- (4) All taxes should treat similarly situated competitors, the same.

# Overview of Electronic Commerce.

In its broadest terms, electronic commerce can be defined as the exchange of goods and services through the use of electronic tools and techniques.<sup>8</sup> In use by large corporations and financial institutions for many years, the meteoric rise in electronic commerce stems largely from the broad availability of low cost personal computers, communications equipment, and competitive access to communications networks.

Recent attention to electronic commerce is due to the proliferation of the Internet as a communications tool used by ordinary citizens. It is a mistake to view the Internet as the only electronic communications link. The future in electronic communications is much more expansive. In the not too distant future traditional telephony, cable, cellular, satellite and other forms of wireless communications will combine to create an interoperable system of digital communications. To the user, the current distinct forms and content of communication will meld into a single communications system permitting wireline and wireless communications from virtually anywhere.

Although commonly referred to as a “thing” or a “place,” the Internet is a world wide interconnection of computers and computer networks that use a common communications protocol, TCP/IP.<sup>9</sup> Created in the late 1960s as a link of military computers, the Internet was designed to be decentralized and therefore capable of automatic routing and re-routing of communications among connected computers or “nodes” in the event that one or more of the them were damaged or destroyed. Communications between users therefore are not dependent upon centralized routing but are advanced by a number of constantly changing routes through the network.

The vast majority of users on the Internet are not “linked” to the Internet. They gain access to the Internet through an Internet Service Provider (ISP) or an On-line Service Provider (OSP). The ISPs, through local Points-of-Presence (POPs), facilitate communications between the local user and other networks on the Internet. The user either accesses via a “dial-up” connection or leases a continuous connection between the ISP’s POP and the user’s computer or network. The connection between the user and the POP is typically provided by the local telephone carrier. The POP then routes the users communications through one or more telephone company networks to the ISPs hub which then routes the communications to a Network Access Point (NAP) for access to the Internet. The NAP’s main function is to act as a point of exchange through which Internet traffic is routed among the servers.



For a dial up user, the location of their POP is only relevant to the cost of their carrier service (or transmission) from their access point to the POP. For example, in my hometown of Stockton, California, there are a number of Internet Service Providers with local POPs. The Stockton user incurs no charges for the length of transmission time by being local. Alternatively, he can dial into that Stockton POP from any other point on the planet, (incurring a long distance charges) through a telephone jack, cellular or satellite link.

While many ISPs provide a multitude of POPs to ensure the consumer always has a local access point, “access” can be gained anywhere. The function of the POP is to provide the consumer with cheaper carrier services. The POP could easily be relocated, even from State to State if government action discourages their placement in a given locale. The growing volume of Internet traffic will permit the market to create other mechanisms for insuring low cost carrier services for the consumer.

The Net’s distributed network architecture also means that the sum of the parts of a particular product (any assemblage of electronic data) can easily be stored on computers with globally diverse geographic locations. The World Wide Web is the most common implementation of this distributed network concept. Built upon the Hypertext Markup Language (HTML), the Web presents a media rich environment within which the user can traverse the Net’s vast information resources. The user is completely oblivious to whether the physical location of the Web site is across the street or continent. Pieces of a single “Web site” could readily be stored on any number of servers in any combination of distinct and geographically diverse locations.

Ernie’s Virtual Emporium could have the code for the main “page” on a server in Toledo, the order forms on a server in Nevada, the software for downloading stored on a server in Canada, and the hardware for shipping in a warehouse in Arizona. The user is unaware of the various locations and for purposes of the Internet the information is irrelevant. The current “Web” permitting the user to search for and “pull” information from places of interest is quickly evolving into an inter-operable system combining the best of all forms of communication (wireline and wireless) and all methods for receiving and distributing information.<sup>10</sup> The result will significantly magnify both the benefits to the user of a distributed network and the difficulties of taxing transactions.

While cyberspace opens new markets for business and unlocks the world’s vast information resources to consumers it presents a major dilemma for government regulators and taxing officials. Because the police power of a state rests largely on its ability to impose sanctions on

violators of the rules it promulgates, the State's ability to coerce behavior is substantially constrained by the need for physical proximity and physical control.<sup>11</sup> The effectiveness of those sanctions are also constrained by the ability of the prospective taxpayer to remove him from the jurisdiction of that State. The Internet presents the ability to evade both detection and sanctions because of its distributed architecture.<sup>12</sup>

## Tax Free Zone.

While the question of *when* convergence from the various telecommunications systems will occur is still speculative, no one disputes the eventuality. As witnessed in California, the different tax treatment of telecommunications carriers, (the Local Exchange, Cellular, and Long Distance Carriers and Cable and Satellite companies) need to be resolved for the economy to maximize the potential of electronic commerce.<sup>13</sup>

Although the primary function of Internet carriers is not electronic commerce, the taxation of telecommunication companies deserves note in this discussion because the current tax structure in many states impedes open competition. Government barriers to open competition are ultimately borne by the consumer. The cost of telecommunication carrier service to the ISPs (who purchase telecommunications services to provide Internet access to their customers) will be artificially inflated. Facilitating the growth of electronic commerce means improving competition among the carriers of telecommunication services.

### ***Taxes on Goods and Services.***

Nationally, 45 States impose a general sales tax.<sup>14</sup> A significant state and local revenue source, the sales tax yields 34% of total state tax revenue and approximately 11% of local government tax revenue nationally.<sup>15</sup> For California, the sales tax comprises approximately 36% of State revenues,<sup>16</sup> 1% of County Revenues, and 10% for Cities.<sup>17</sup>

The sales tax is largely a creature of the depression era. Struggling to find a source of revenues to fund substantial increases in government activities, more than half the states turned to a tax on the retail sales of tangible goods. Because retail transactions were viewed largely as an intrastate activity it was relatively easy to impose on merchants to pay, collect, and remit the tax--making administration efficient. The sales tax was politically viable because it was a relatively small percentage paid in small increments and those most impacted by it, the poor and middle class, were less active in the political process.<sup>18</sup>

Recognizing large purchases could provide an incentive on the part of large institutional buyers to travel out of state to purchase goods for in state use, most states adopted a “compensating” Use tax. The Use tax is intended to tax the *use* of goods purchased in another state where that transaction was not subject to an equal or greater rate of taxation.

The Use tax has often been promoted as a mechanism for protecting intrastate merchants from unfair out-of-state competition. The flaw in this argument is that for the vast majority of consumers, the differential in tax rates simply isn’t a motivating factor in whether to buy local or by through the mail. When the additional costs of shipping are considered, shopping by mail seems to have more to do with convenience than taxes or price.

### ***Problems with the Sales & Use Tax in Cyberspace.***

The weakest link in the Sales and Use tax structure is clearly the Use tax because the transactions subject to tax occur outside the state. Collection efforts focus almost exclusively on vendors that reside beyond the borders of the State. Historically the Use tax has detected and collected only the largest of purchases by consumers and businesses. The average consumer’s purchases were considered relatively small and too costly to collect. Advances in telecommunications, shipping, and consumer acceptance of mail order type transactions, has made tax administrators nervous over the potential erosion of their sales tax base. The reality is that electronic commerce is a relatively small piece of the overall consumer expenditure pie. Even with the highest estimate of \$600 billion for global Internet purchases for the year 2000, total expenditures in electronic commerce will still comprise only 7.5% of total global expenditures.<sup>19</sup>

What is most ironic about the Use tax is that the public is completely unaware of its existence despite being responsible for its payment. Instead of focusing efforts on collecting the tax from the user, the States largely focus on extending their reach to out-of-state merchants in an attempt to force those business to pay or collect and remit the tax.<sup>20</sup> These out-of-state businesses can’t vote against local politicians.

In the nomenclature of State taxation, the word *nexus* is often used to describe the circumstances in which an out of state taxpayer has made sufficient contact with a State to warrant taxation of transactions or income derived from that contact. The power of a State to force payment of tax by out-of-state businesses is limited by both the Commerce Clause (in its “dormant phase”) and the Due Process Clause of the U.S. Constitution.<sup>21</sup>

Not to suggest that the States cannot act on their own to voluntarily limit their reach. Asking any State to voluntarily limit their taxing jurisdiction is comparable to asking a dog to give up his last bone. The dog don't hunt and won't give up his bone. Regrettably, the Courts have been the primary source of law on what degree of contact with a State is sufficient to create nexus. State and business interests have been in protracted legal disputes for the past three decades attempting to resolve the matter, benefiting no one but the lawyers.

While Governors and economic development officials of many States are working overtime to retain and attract employers, "revenue commissioners are tracking down and squeezing corporate taxpayers for every available cent."<sup>22</sup> A recent Coopers & Lybrand study reported in CFO magazine, "58 percent of fast growth companies saw their proportionate state and local tax bills increase by an average of 27.2 percent."<sup>23</sup> The fundamental problem created by the Courts and tax administrators for taxpayers is a substantial degree of uncertainty. According to a recent KPMG Peat Marwick survey reported in the same article, 35 percent of CFOs and tax directors now say nexus uncertainty is their top State tax concern, outpacing apportionment and audit concerns.<sup>24</sup>

A band of States organized by the Multistate Tax Commission (MTC) continue to pursue this theory of "economic presence" giving rise to nexus. Their argument is a business that derives a benefit from the market of a State should be subject to tax on the benefit derived from that State. Despite repeated rejections by the Courts, the MTC continues to grasp for judicial precedent to support taxing "any thing that moves."

The point isn't who is right or wrong on nexus questions, but whether Courts are left, or on its own decides, to make the law. The commerce clause on its face is merely a grant to Congress of the power to regulate commerce among the states. It was judicial *interpretation* which began the process of contracting and expanding State power over interstate commerce.<sup>25</sup> The decision of whether to limit state power to tax is legislative in nature, not judicial. As a result, the Court has substantially limited the people's representation on the issue and left the debate to unelected tax bureaucrats, judges, and industry lawyers. Government not by the people, but whoever achieves the highest LSAT score.

The next battle ground over nexus undoubtedly will be the Internet and electronic commerce. Some state tax agency lawyers have already asserted that someone who maintains a web site on a server in that State which includes advertising and takes orders has nexus.

Recognizing that their theories of economic presence have yet to obtain credible support in the Courts, they have shifted focus to the “agency” relationship between the out-of-state merchant and the in-state web hosting service (possibly an ISP or possibly a party unrelated to the web hosting service provider). Arguing that the ISP’s nexus should be attributed to the out-of-state merchant thereby snaring the out-of-state merchant within the jurisdiction of the state.<sup>26</sup>

Those aggressively pushing nexus liability in electronic commerce clearly have little understanding of the potential capability of technology. The ISP may not even own the server which is being used to provide service or have any idea where it is located. To provide for continuity of service, the ISP likely has a redundant backup system which switches automatically in case of equipment failure or power outages. Such backup servers can easily be located in geographically diverse locations. It is ludicrous to argue that such activity creates nexus.

The distributed architecture of the Net means moving the physical location of the server is relatively simple and inexpensive. There is likely little correlation between an Internet server’s location and the marketplace. If a State actually attempts to assert nexus in such cases, the Web hosting business will likely move to other non-taxing jurisdictions, whether across State lines or national borders. The impact to the consumer is nil. The user has no idea, and doesn’t care, where the server hosting the web site is located. The only economic consequence of pursuing this expansion of nexus is to encourage the jobs associated with developing electronic commerce to move to another State or another country.

The government burden for tax administration should be measured against the cost for administering the Use tax incurred by the merchant. The States often argue that the Use tax is a method for protecting in-state merchants from unfair competition from out-of-state vendors who were not required to collect and remit the tax. Acknowledging some sentimental appeal to this theory, reality is quite different in the light of the information age.

For traditional “main street merchants” the sales tax assumes the place of purchase is also the place of consumption. As a result there is a single sales tax rate for that merchant on all sales. Most likely the merchant reports sales and Use tax information and remits payment to a single entity of government. For the main street merchant there is a single body of law addressing what is subject to tax, the procedures that must be followed, and data to be reported. Usually a single entity of government subjects his records to audit and provides a mechanism for protest should a dispute between them arise.

The practical reality for the out-of-state vendor is not one State law to apply, but fifty. Given the global implications of the Internet, potentially hundreds of jurisdictional laws to apply. The vendor might not know which body of law to apply to a particular transaction because the consumer's current location is likely outside the vendors knowledge and the consumer's intended place of use. There is not one rate to apply to all sales of taxable goods, because many States permit cities and counties to impose sales and use taxes. For the out-of-state vendor, there isn't a single auditor but potentially multiple auditors, potentially for different audit periods all coming and going without coordination among them. Should a dispute arise between the vendor and the taxing agency, there isn't a single forum in which to air their complaints. To pursue their disputes with the taxing agency would require their physical presence in the forum state and be in geographically diverse locations costing substantial resources to pursue.

If State tax bureaucrats are successful in their aggressive pursuit of nexus on the Internet, the taxpayer that is caught won't be big merchants like Lands End, but your next door neighbor. It will be the small businesses and entrepreneurs who will be discouraged from developing their virtual businesses because of the uncertainty of the law and the potential costs of being wrong.

# Solutions.

The debate over the taxation of electronic commerce is a debate about the role of government as much as what tax structure adheres to the principles of economic neutrality. Seizing upon the recent shift in power in Congress, some of the States have begun a campaign to dissuade congressional involvement in the nexus debate. Any solution to the States tax policies, they argue, should be left to the States to resolve among themselves. Adherence to “State’s rights” then requires that one be necessarily against Congressional involvement in such matters of State tax policy.<sup>27</sup> I doubt the current Congress is losing sleep over the State’s authority to extract tax from the Internet.

Their arguments are partially correct. Federalism is indeed about the division of powers among the federal and state governments. The Founding Fathers created a system of government with several checks and balances between both the national government and the States. The intent was not solely to secure power in the States as opposed to the federal government. Instead, the Founders sought to provide a system of checks to the arbitrary and overreaching powers of *both*.<sup>28</sup>

The primary check on overreaching state actions was the power granted to Congress to regulate commerce between the several States. This specific grant of power was adopted primarily in response to the economic problems the nation experienced under the Articles of Confederation.<sup>29</sup> The Confederation specifically prohibited the national government from regulating trade among the States.<sup>30</sup> As a result, individual states began imposing taxes on goods from other states. Both Madison and Hamilton were concerned this controversy could lead to armed conflict among the States or permit the meddling of other nations threatening the nation’s security.<sup>31</sup> The Commerce Clause was written as a cure to these structural impediments to the nation’s development.<sup>32</sup>

The resurgence in Congress to the ideals of federalism and returning program responsibility to the States is sorely needed. States which argue that this federalism protects their unrestrained regulation (and taxation) of interstate commerce are clearly misreading the Constitution and the writings of both Hamilton and Madison.<sup>33</sup> The model of unchecked State power in the regulation and taxation of interstate commerce was the Articles of Confederation. Although promoted with artful fervor by the “Anti-federalists,” ultimately their idea of an omnipotent State with respect to the regulation and taxation of interstate commerce was decisively rejected.

Regrettably, during the past 200 years an activist federal judiciary has largely usurped Congress' intended role as a check on State power with respect to interstate commerce.<sup>34</sup> Notwithstanding the inappropriateness of judicial lawmaking, the Courts have failed to solve the problems. States continue to pursue the expansion of their taxing powers through litigation and threat of legal action.<sup>35</sup> Industries engaged in interstate commerce continue to face uncertain tax liabilities<sup>36</sup> and the chilling threat to the growth of electronic commerce continues unabated.<sup>37</sup>

The architecture of the Internet renders irrelevant geopolitical borders and ushers in a new era of global commerce. Tax compliance issues, even for the smallest of businesses, becomes international in scope. The lack of State and local tax uniformity for electronic commerce will substantially impede the United States' ability to negotiate fair trade and tax policies with our international trading partners.<sup>38</sup> The need for a single voice in foreign affairs is at the very heart of our system of government. To the extent the States are permitted to undermine that voice, the well being of the whole is jeopardized.<sup>39</sup>

States cannot collectively solve the problem of nexus and will not voluntarily relinquish the power to tax access to the Internet or electronically delivered goods and services. A few States will ease their interpretations of nexus as they realize the greater benefits of attracting businesses associated with electronic commerce.<sup>40</sup> Frankly, I believe California policy makers will pursue the path of lower tax and less regulation on technology. Many more States will continue the mindless pursuit of more revenue. The competition among the State tax agencies will itself prevent uniformity. Ultimately, the difficulties of drafting a uniform solution and winning passage in 50 State legislative bodies will prove self imposed uniformity among the States impractical.

The threat of taxation to electronic commerce has not been entirely a State effort. Some of the more visible efforts to tax Internet activity are by local governmental units.<sup>41</sup> If a uniformity effort among the States was successful there is some question as to whether it could include limitations on local governments.

It is time for Congress to reassert itself as the constitutional protector of interstate commerce. To exercise the power the Founding Fathers intended and ensure that the promise of the information age is realized for the American people. The alternative, no congressional limits on Internet taxes, will squander our future by over zealous State tax collection. The U.S. Supreme Court has recognized the need for congressional action on the subject of State taxation of interstate commerce.<sup>42</sup>



Congressional action does not require a federal take over of State taxing authority, nor is that desirable. It simply requires that Congress, in light of the tremendous potential of economic growth in interstate commerce and electronic commerce take the following steps:

*(1) Prohibit State and local governments from imposing any new taxes on access to the Internet.*

The people will benefit more through the rapid expansion of electronic commerce than by any marginal tax revenue derived from imposing new taxes on Internet access. The downside of taxation will be stifling the growth of electronic commerce and burdening the production of high-wage earning jobs that should be welcomed in any community.

*(2) Prevent State and local governments from imposing any taxes on electronically delivered goods and services.*

President Clinton has called for the delivery of products and services across the Internet to be “duty free.”<sup>43</sup> The Administration sees commerce on the Internet as one of the most important areas for accelerating the growth of U.S. exports and the economy in general. Without a limitation on the States to impose taxes on electronically delivered products and services, the international concept of a “duty free” Internet becomes a fiction.

*(3) Clearly define nexus to require actual physical presence by the merchant before a State can impose Use tax collection and remittance requirements. Congress should include specific language establishing that Internet activity and contracts for services are insufficient to establish nexus.*

It is ironic that until 1984 the Multistate Tax Commission actually adopted a uniform definition of nexus which was removed to pursue theories of “economic presence nexus.” The standard was as follows:

#### SALES AND USE TAX JURISDICTION STANDARD

A vendor is required to pay or collect and remit the tax imposed by this Act if within this state he directly or by any agent or other representatives:

1. Has or utilizes an office, distribution house, sales house, warehouse, service enterprise or other place of business; or
2. Maintains a stock of goods; or
3. Regularly solicits orders whether or not such orders are accepted in this state, unless the activity in this state consists solely of advertising or of solicitation by direct mail; or
5. Regularly engages in any activity in connection with the leasing or servicing of property located within this state.

This state does not seek to impose use tax collection requirements on any retailer over whom the above standard does not confer jurisdiction in this state. [incorrect numbering in original].

According to a letter prepared by MTC General Counsel Paull Mines, the pre-1984 MTC standard disfavor stemmed primarily from its last sentence limiting nexus to the terms defined by the uniform statute. "Maybe the re-promulgation could state that these standards are ones of clear, indisputable nexus and that the absence of other factual circumstances giving rise to nexus does not suggest that those circumstances do not give rise to nexus."<sup>44</sup> Translation: This is nexus. Anything else might be nexus too if we can simply convince the Court. This succinctly defines the current dilemma with respect to nexus. Standards that have been promulgated by the Court have been insufficient to provide any degree of certainty necessary for the taxpayer to conduct business. Heads tax it, tails sue the taxpayer.

## Conclusion.

There are certainly a number of reasons why the Internet has grown so quickly and become such an active part of our future. Its vitality, has as much to do with its expression of freedom as its potential for commerce. Not since our nation was founded have we been so liberated from the constraints of government as we now are in cyberspace. The consequences of Congress failing to take affirmative steps to halt the over reaching activities of the States in taxing interstate commerce will be the continued waste of the taxpayer's money in protracted litigation, uncertainty in the business community on nexus, and the dampening of the spirit of freedom that energizes the Internet.

Most important of many issues of electronic commerce is that our actions on the Internet have global ramifications. Other nations are

watching how the United States comes to grips with the realities of the global communications network. If the States are left unchecked, the global reach of the Internet will allow them to affect America's foreign policy. To the extent that one or more of our States overreach in the zealous pursuit of revenues, other nations adversely affected may retaliate. More likely the ambitious nation will seek advantage over the United States by declining to tax electronic commerce and Internet access.

At the end of the day, the potential balkanization of the Internet is advantageous to no one. Perhaps we can address President Reagan's wise observation regarding governmental interference in the economy and take specific action to avoid taxing the Internet. We all would benefit.

# Endnotes

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Dean Andal was elected to the State Board of Equalization in 1994 to represent the Second District which includes the central valley, Inland Empire and the central coast of California. Dean began his public service as an assistant to then Congressman Norm Shumway (R-Stockton). Before seeking elective office, he was an independent businessman operating Andal Communications, a bank and real estate marketing company. Mr. Andal was a California State Assemblyman for two terms. As a Board of Equalization Member, Mr. Andal has implemented an intensive office consolidation within the 28 counties he represents saving taxpayers an estimated \$40 million. Most recently, his effort to cut State spending focused on the State Board of Equalization resulting in a 1997-98 fiscal year budget with an actual reduction in its request for operating funds.

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1. WILLIAM GIBSON, *NEUROMANCER* 51 (1984).
2. Maria Seminerio, PC Week Online, <http://www.pcweek.com/news/0401/01mcp.html> (April 1, 1996); See also Killen & Associates as reported at the Silicon Valley Internet Tax Policy Conference, Santa Clara California, January 1997 by Magdalena Yesil.
3. *Forecast Number of Internet Users, Worldwide*, Computer Industry Forecasts, Oct 15, 1996, available in LEXIS, Nexis Library, Busref-Stats file.
4. *Forecast Investments in Internet Infrastructure*, Computer Industry Forecasts, Oct 15, 1996, available in LEXIS, Nexis Library, Busref-Stats file.
5. *Forecast Spending on Internet Equipment*, Computer Industry Forecasts, Oct 15, 1996, available in LEXIS, Nexis Library, Busref-Stats file.
6. *Forecast market for Internet-related outsourcing services*, Computer Reseller News, July 1, 1996 pg. 41, , available in LEXIS, Nexis Library, Busref-Stats file.
7. ON MATTERS OF MOST GRAVE CONCERN at <http://www.greatbasin.net/~doconnor/>.
8. *Electronic Commerce in the NII*, XIWT (Cross Industry Working Team) 1996 available at [http://www.cnri.reston.va.us:3000/XIWT/documents/EComm\\_doc/ECommTOC2.html](http://www.cnri.reston.va.us:3000/XIWT/documents/EComm_doc/ECommTOC2.html)
9. Transmission Control Protocol/Internet Protocol. Henry H. Perritt, Jr., *What is the Internet?* available at <http://www.law.vill.edu/vclip/technotes/whatis5.htm>. See also *Logging On to Cyberspace Tax Policy White Paper*, Interactive Services Association (ISA) available at <http://www.isa.net/about/releases/taxwhpap.html>.
10. See Kevin Kelley and Gary Wolf, *Push*, Wired, March 1997, 5.03, pg 12 also available at <http://www.wired.com/wired/>.
11. See David G. Post, *Anarchy, State, and the Internet: An Essay on Law-Making in Cyberspace*, 1995 J. ONLINE L. art. 3.
12. *Id.* at par. 39
13. See DEAN ANDAL, THE ANDAL REPORT: TAXATION OF TELECOMMUNICATIONS AND ENERGY IN CALIFORNIA, January 1997 available by request from [gturner@boarddist2.boe.ca.gov](mailto:gturner@boarddist2.boe.ca.gov).
14. JOHN F. DUE AND JOHN L. MIKESSELL, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION, Urban Institute Press, ©1994 at 1.
15. *Id.*
16. Gov. Pete Wilson, *Governor's Budget Summary*, 1996-97, p. 57.
17. HELEN C. PAIK, LOCAL GOVERNMENT FINANCES SINCE PROPOSITION 13: AN HISTORICAL PRIMER, Nov. 1995. CALIFORNIA RESEARCH BUREAU, CALIFORNIA STATE LIBRARY
18. *Id.* at 8.

19. Killen & Associates as reported at the Silicon Valley Internet Tax Policy Conference, Santa Clara California, January 1997 by Magdalena Yesil.

20. The exception to the rule is the State of Maine that has made a concerted effort to educate the public on their liability for the use tax and provide a line on individual tax returns to facilitate the collection of the tax. See <http://www.state.me.us/taxation/homepage.htm>

21. *Quill Corp. v. North Dakota*, 112 S.Ct. 1904, 1909 and 1913 (1992).

22. Ian Springsteel, State Taxes: A Guide for the Besieged, CFO Magazine August 1996, at 29.

23. *Id.*

24. *Id.*

25. See Earl M. Maltz, *The Impact of the Constitutional Revolution of 1937 on the Dormant Commerce Clause - A Case Study in the Decline of State Autonomy*, 19 HARV. J.L. & PUB. POL. 1, at 121 (1996).

26. The primary authority relied upon is the 1960 US Supreme Court case of *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960) which held that a Georgia corporation engaged in the business of selling mechanical writing instruments through “jobbers” or “independent contractors” in Florida had nexus in Florida. State reliance on this case is questionable for a couple of reasons: (1) there is a strong argument that this case was a Due Process analysis, *Quill* by recognizing the distinctions between Due Process and the Commerce Clause created a higher standard for the Commerce Clause analysis; and (2) the constitutionally significant issue wasn’t that the jobbers were independent contractors but that every aspect of the sale, except acceptance, occurred within the State of Florida.

27. See Multistate Tax Commission “Statement of Direction on Electronic Commerce Issues” January 17, 1997 available by contacting the MTC at <http://www.mtc.gov>.

28. Douglas Seay and Wesley Smith, *Issues '96: The Candidates' Briefing Book*, available at <http://www.heritage.org/heritage/issues96/chpt4.html>

29. NOTE: UNITED STATES V. LOPEZ, REAFFIRMING THE FEDERAL COMMERCE POWER AND REMEMBERING FEDERALISM, 45 CALIF. U.L. REV. 1459, n. 1. Citing Thomas H. Calvert, Regulation of Commerce Under the Federal Constitution 3 (1907).

30. UNITED STATE ARTICLES OF CONFEDERATION, ART. IX.

31. “It is sometimes asked, with an air of seeming triumph, what inducements could the States have, if disunited, to make war upon each other? It would be a full answer to this question to say--precisely the same inducements which have, at different times, deluged in blood all the nations in the world. . . The competitions of commerce would be another fruitful source of contention. The States less favorably circumstanced would be desirous of escaping from the disadvantages of local situation, and of sharing in the advantages of their more fortunate neighbors. Each State, or separate confederacy, would pursue a system of commercial policy peculiar to itself. This would occasion distinctions, preferences, and exclusions, which would beget discontent.” THE FEDERALIST NO. 7 (Alexander Hamilton). See also THE FEDERALIST NOS. 11 (Alexander Hamilton) and 42 (James Madison).

32. See generally THE FEDERALIST NOS. 7, 11 (Alexander Hamilton) and 42 (James Madison).; See also, *Quill v. North Dakota*, 112 S.Ct. 1904, 1913 (1992)

33. “The defect of power in the existing Confederacy to regulate the commerce between its several members, is in the number of those which have been clearly pointed out by experience. . . The necessity of a superintending authority over the reciprocal trade of confederated States, has been illustrated by other examples as well as our own.” THE FEDERALIST NO. 42 (James Madison). See also THE FEDERALIST NO. 33 (Alexander Hamilton) (discussing the nature of the supremacy clause).

34. See Martin H. Redish and Shane V. Nugent, *The Dormant Commerce Clause and the Constitutional Balance of Federalism*, 1987 DUKE L.J. 569 (1987).

35. “Their strategy [the States] is to create a large enough downside risk that a theory may actually work.” George Isaacson, at the Silicon Valley Internet Tax Policy Conference January 19, 1997.

36. See Eisenstein, *The Constitutional Limits on Sales Taxation of Cyberspace*, 97 STN 37-44 (1997).

37. The threat to electronic commerce can be as much by perception as by actual conduct. “The emerging market for electronic commerce could be crushed, industry leaders say, if cities and counties begin approving taxes for telecommunications, data processing services or even sales. They say Internet service providers could be driven out of business if local governments get the right to tax an electronic transaction that just happens to be routed through a local computer server en route to its final destination.” *Internet leaders see taxes as threat*, SAC. BEE, Feb. 26, 1997, § D, at 2.

38. Madison understood that the power to regulate foreign commerce was incomplete without the corresponding power to regulation interstate commerce. “To the proofs and remarks which former papers have brought into view on this

subject, it may be added that without this supplemental provision, the great and essential power of regulating foreign commerce would have been incomplete and ineffectual.” THE FEDERALIST NO. 42 (James Madison).

39. “Suppose, for instance, we had a government in America, capable of excluding Great Britain (with whom we have at present no treaty of commerce) from all our ports; what would be the probable operation of this step upon her politics? Would it not enable us to negotiate, with the fairest prospect of success, for commercial privileges of the most valuable and extensive kind, in the dominions of that kingdom?” THE FEDERALIST NO. 11 (Alexander Hamilton).

40. See Press Release from George Pataki, Gov. State of New York, Jan. 10, 1997 available at [http://www.state.ny.us/governor/press/jan10\\_3.html](http://www.state.ny.us/governor/press/jan10_3.html).

41. For example the recent effort in Tacoma Washington to impose a 6% tax on Internet access. See AP On-line, July 8, 1996, Section Financial Pages, available in LEXIS, Nexis Library, curnws file.

42. “This aspect of our decision [to reaffirm the *National Bellas Hess* bright line rule] is made easier by the fact that the underlying issue is not only one that Congress may b better qualified to resolve, but also one that Congress has the ultimate power to resolve.” *Quill Corp. v. North Dakota*, 112 S.Ct. 1904, 1916 (1992).

43. Draft #9, A FRAMEWORK FOR GLOBAL ELECTRONIC COMMERCE available at [http://www.iitf.nist.gov/eleccomm/glo\\_comm.htm](http://www.iitf.nist.gov/eleccomm/glo_comm.htm).

44. Letter to State Personnel Interested in Historical Nexus from Paull Mines, General Counsel, Multistate Tax Commission, July 26, 1996.